

Excise Tax Advisory

Excise Tax Advisories are interpretive statements authorized by RCW 34.05.230.

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International Investment Management Services

Purpose

The purpose of this Excise Tax Advisory is to clarify for taxpayers the qualifications and application of the lower tax rate (RCW 82.04.290(1)) for international investment management services defined in RCW 82.04.293.

Investment Management Services

When is a person engaged in the business of providing investment management services?

RCW 82.04.293(2) states that “investment management services” means investment research, investment consulting, portfolio management, fund administration, fund distribution, investment transactions, or related investment services.

Because the activity being taxed is “investment management services,” we interpret this definition to require some management component in ~~each of~~ the enumerated services. “Investment management” means ~~an agency relationship~~ discretionary authority wherein financial investment decisions are not directly controlled by the client, but the client may provide investment objectives and parameters to the investment manager. For example, a broker-dealer transaction may incidentally involve investment research or investment consulting, but such transactions are not considered “investment management services” because they lack the requisite management component. Another example of these differences is illustrated in Part 1A, Item 5(G) when compared to Item 6(A) of the Securities and Exchange Commissions’ uniform form (Form ADV) that investment advisers use to register. “Investment management” does not include “impersonal investment advice” which is defined in the Form ADV glossary as investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts.

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Also helpful in drawing this distinction is the description of an investment adviser in Section 2(a)(20)(A) of the Investment Company Act of 1940 which includes a person who regularly furnishes advice with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold, but does not include a person whose advice is furnished solely through uniform publications distributed to subscribers thereto, furnishes only statistical and other factual information, advice regarding economic factors and trends, or advice as to occasional transactions in specific securities, but without generally furnishing advice or making recommendations regarding the purchase or sale of securities. Accordingly, investment management services are services in which the investment manager has investment discretion as defined in the Securities Exchange Act of 1934, Section (3)(a)(35). is authorized or permitted to modify the client's investments without direct involvement by the client.

“Primarily”

When is a person engaged “primarily” in the business of providing investment management services?

A person is “primarily” engaged in the business of providing investment management services when more than fifty percent (50%) of that person’s activities under the Service & Other Activities B&O tax classification are investment management services. Activities can be characterized either by income earned or by expenses incurred. Therefore, a taxpayer must show that more than 50 percent of either (1) its gross income is from investment management services or (2) its total expenditures are incurred in support of its investment management services.

If a person qualifies for the international investment management services classification, then their income otherwise subject to Service & Other B&O tax qualifies for this special tax rate.

10% of Gross Income

What percent of gross income for a person engaged primarily in the business of providing investment management services must be derived from rendering those services to qualified clients?

At least ten percent of the person’s total gross income must be from those investment management services provided to qualifying clients. RCW 82.04.293(1)(b)

Each client must be considered independently and not collectively. Income from those clients that individually qualify must make up at least ten percent of the taxpayer’s gross income. Form ADV, Part 1A, Item 5(C) and (D) provide an example of how to determine who each client is.

**Qualifying
Client**

Who is a qualifying client?

RCW 82.04.293(1)(b) identifies two types of qualifying clients. Both types of qualified clients consist of persons or collective investment funds. The first type of qualifying clients reside outside the United States. The second type of qualifying clients reside in the United States and have at least ten percent of their investments located outside the United States.

**Income and
Clients**

What is the relationship between income and client requirements?

The ten percent of taxpayer's total gross income may come from one type of client or the other or any combination of the two types of clients. For example, a taxpayer would meet this requirement of the statute if ten percent of its gross income comes only from the first type of qualifying clients (those who reside outside the United States). Another taxpayer would meet this requirement if ten percent of its income was generated from the second type of qualifying clients (those who reside in the United States and have at least ten percent of their investments located outside the United States). Another taxpayer would meet this requirement if five percent of its income was generated from the first type of qualifying clients and five percent of its income was generated from the second type of qualifying clients for a total of 10% of its income being generated from qualifying clients.

**Type 1 – Reside
Outside the
U.S.**

When is a client residing outside the United States (the first type)?

Individuals establish residence by physical presence and intent to make a particular place a home. A corporation or other legal entity may be a resident of multiple places dependent on where it transacts business.

Not every individual or legal entity with a foreign mailing address is a foreign resident. A foreign mailing address alone does not provide proof of the requisite degree of permanent attachment to a foreign location. Records showing a foreign mailing address provide some evidence of residency, but are independently insufficient to prove foreign residency.

The Department will not attempt to detail an exclusive list of documentation or means by which a taxpayer could corroborate the mailing address as the client's residence. Taxpayers must provide information to show residency outside the United States. Examples of corroborating evidence of residency can be found in the US Patriot Act and federal income tax regulations. However, these examples are by no means exclusive standards by which a taxpayer must establish residency of clients. Item 5(C)(2) of Form ADV, Part 1A is also an indicator of Type 1 clients as it uses the definition of "U.S. person" found in Rule 902(k) or Regulation S under the Securities Act, but the Department may request further information to verify non-United States persons' residence outside the United States.

**Type 2 – 10%
Outside the
U.S.**

When does a client have at least ten percent of their investments located outside the United States (the second type)?

To determine if a client has at least ten percent of their investments outside the United States, the taxpayer must determine: (1) the client's total investments and (2) the client's total qualified investment. Then simply divide the client's total qualified investments by the client's total investments. If the result is 10% or more, then the client is a Type 2 client.

**"Their
Investments"**

What are "their investments"?

"Their" refers to the client. "Their investments" means the assets of the taxpayer's clients managed by the investment manager on a discretionary basis. For example, the methodologies used to determine the taxpayer's discretionary regulatory assets under management for purposes of reporting All of the client's investments are "their investments." The taxpayer should not distinguish between whether the investments are managed by the taxpayer or managed by someone else to determine the client's total investments on Form ADV, Part 1A, Item (5)(F)(2) would be acceptable for determining "their investments."

**Qualified
Investment of
Persons or
Collective
Investment
Funds**

How do you determine a client's investments qualify as outside the United States?

Type 2 clients can be a person or a collective investment fund.

1. When a client is a person, the taxpayer must look at the person's investments (personal investments) with a beneficial interest in the underlying assets. If the underlying assets are outside the United States, then the investment is qualified.
- 1.2. When a client is a collective investment fund, the taxpayer must look at the underlying assets of the fund since the collective investment fund is a beneficial interest in the underlying assets for the fund investors.

**Beneficial
Interest in
Underlying
Assets**

What investments constitute a beneficial interest in underlying assets?

RCW 82.04.293(4) states: "Investments are located outside the United States if the underlying assets in which the investment constitutes a beneficial interest reside or are created, issued or held outside the United States."

The personal investment must constitute a beneficial interest in the underlying assets. Therefore, qualifying personal investments are only those with a beneficial interest in the underlying assets issued or held outside the US. For example, mutual funds may qualify as an investment for purposes of this statute because they create a beneficial

interest in the underlying fund assets. But individual stock ownership would not qualify as an investment for purposes of this statute, because individual stock ownership does not create a beneficial interest in underlying assets.

However, the collective investment fund is an investment with a beneficial interest, so the underlying assets are the securities held by the collective investment fund.

**Underlying
Assets**

When are the underlying assets in which the investment constitutes a beneficial interest located outside the United States?

The underlying assets of an investment must reside or be created, issued or held outside the United States. Determining where the underlying asset in which the investment constitutes a beneficial interest is located is a simple inquiry. For example, a mutual fund with underlying assets of shares in US Company X is located or resides in the US regardless of where purchased or what assets US Company X owns. Correspondingly shares of Foreign Company Y are located or reside outside the US even if purchased on an American exchange (for example as an American Depository Receipt). Here the statute essentially requires that investment be assigned a residence, parallel to determining the residence of individual qualifying clients in the first type.

**Collective
Investment
Fund Example**

The International Small Sector Fund (ISSF) invests in small companies around that world that specialize in cheese making. ISSF hires Spork Investments (Spork) as its investment manager to pick which small cheese making companies around the world it will invest in per its investment goals. ISSF is registered and issued in the United States. Spork is the taxpayer and believes it qualifies for the IIMS classification. ISSF is one of four clients, but provides 30% of Spork's income. ISSF is not a Type 1 client because it is a collective investment fund residing in the United States. However, ISSF is a Type 2 client because it has over 10% of its money invested in cheese making company stock issued outside the United States.

Verification

How often should a taxpayer verify that it still qualifies for the international investment management services lower tax rate?

A taxpayer must periodically review the source of its income to determine whether it continues to meet the necessary criteria to report income under the international investment management services B&O tax classification, which may be subject to future audit verification.

For example, a particular taxpayer may have a very consistent client base that does not vary or fluctuate significantly. For such a taxpayer, a single verification date each year may be appropriate. Conversely, a taxpayer's client base may fluctuate significantly, which would render a single verification date inaccurate for their regular business practices. For example, if a taxpayer is filing an amendment to its

Form ADV, it may also be appropriate to review the source of its income for B&O tax purposes. Therefore, taxpayers must review the source of their income ~~at least~~ annually, but ~~should~~ the Department may require ~~do so~~ more frequently analysis.

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